October 8, 2004

CERTIFIED MAIL
RETURN RECEIPT REQUESTED

Reference No.: 04-0083

Mr. Phil Leong
Rail Surveyors & Engineers, Inc.
373 Fourth Street, Suite #3A
Oakland, CA 94607

Dear Mr. Leong:

This is in response to the appeal that you filed on behalf of your firm, Rail Surveyors & Engineers, Inc. (RSE). We have carefully reviewed the material from the San Mateo County Transit District's, California Unified Certification Program (CUCP) as well as that submitted by you and have concluded that the denial of RSE 's certification as an eligible DBE under criteria set forth in 49 CFR Part 26 ("the Regulation") is supported by substantial evidence.

Your appeal is denied based upon a determination that ownership and control by you, the disadvantaged owner, is not real, substantial and continuing as required by 49 CFR Part 26.69 and 26.71; and that you do not possess the power to direct or cause the direction of the management and policies of the firm and to make day-to-day as well as major decisions on matters of management, policy and operations.

How are burdens of proof allocated in the certification process? The Regulation provides that firms seeking DBE certification has the burden of proof by demonstrating to the recipient, that they meet the requirements of the regulation for group members, individual disadvantage, business size, ownership, and control, by a preponderance of the evidence (more likely than not). In reviewing all facts of the record, this office has concluded that RSE failed to meet its burden of proof, by a preponderance of the evidence, with regards to ownership and control.

The specific reasons for the denial of your appeal include the following:

1) The Regulation at §26.69(b) states that to be an eligible DBE, a firm must be at least 51 percent owned by socially and economically disadvantaged individuals. In the case of a corporation, such individuals must own at least 51 percent of the each class of voting stock outstanding and 51 percent of the aggregate of all stock outstanding. In the case of a partnership, 51 percent of each class of partnership interest must be owned by socially and

economically disadvantaged individuals. Such ownership must be reflected in the firm's partnership agreement. In the case of a limited liability company, at least 51 percent of each class of member interest must be owned by socially and economically disadvantaged individuals.

The Regulation at §26.69(c) in part, provides that contributions of capital or expertise by the disadvantaged owner to acquire an ownership interest in the participating DBE business be real and substantial and continuing, going beyond pro forma ownership of the firm as reflected in ownership documents. The disadvantaged owners must enjoy the customary incidents of ownership, and share in the risks and profits commensurate with their ownership interests, as demonstrated by the substance, not merely the form, of arrangements.

The CUCP based its decision, in part, to deny RSE certification on the fact that you, the disadvantaged owner, do not own at least 51% of RSE, a firm originally established in 1996. The record evidence reveals that the applicant firm was originally established as a partnership under the name Rail Surveyors in 1996 between Kevin Gray and John Schock. The firm is currently owned by you, the disadvantaged owner, Kevin Gray and John Schock, both non-disadvantaged individuals.

The record information further reveals that RSE was incorporated in September of 2001. According to the minutes of the Board of Directors meeting held January 20, 2002, you the disadvantaged owner initially owned 10,000 shares of stock, with both of the non-disadvantaged owners equally holding 10,000 shares of stock in RSE. Therefore, each owner had 33.333% ownership interest. In January of 2003, you acquired an additional 10,816 shares to acquire majority ownership interest in the applicant firm. The agreement states, "RSE. Inc. will issue additional shares at $1.00/share to Phil Leong, with the intent of increasing his ownership stake to 51%, and decreasing the ownership stake of Kevin C. Gray and John C. Schock to 24.5% each." When calculating your ownership interest, it appears you hold only 50.9996% of ownership interest in the firm. We conclude, therefore, that the requirement of the Department's Regulation that a participating DBE be at least 51 percent owned by a disadvantaged individual, and that ownership be real and substantial, has not been satisfied.

2) The Regulation at §26.71(d) requires in part, that the disadvantaged owner possess the power to direct or cause the direction of the management and polices of the firm and to make day-to-day as well as long-term decisions on maters of management, policy and operations. A disadvantaged owner must hold the highest officer position in the company (e.g. chief executive officer of president). In a corporation, disadvantaged owners must control the board of directors.

Under the Regulation at §26.71(e) individuals who are not socially and economically disadvantaged may be involved in a DBE firm as owners, managers, employees, stockholders, officers, and/or directors. Such individuals must not, however, possess or exercise the power to control the firm, or be disproportionately responsible for the operation of the firm.

The Regulation §26.71(f) states in part, that a disadvantaged owner may delegate various areas of the management, policy making, or daily operations of the firm to other participants in the firm, regardless of whether these participants are disadvantaged individuals. Such delegations of authority must be revocable, and the disadvantaged owner must retain the power to hire and fire any person to whom such authority is delegated. The managerial role of the disadvantaged owner in the firm's overall affairs must be such that the recipient can reasonably conclude that the disadvantaged owner actually exercises control over the firm's operations, management, and policy.

Under the Regulation at §26.71(i)(1), recipients may consider differences in remuneration between the disadvantaged owners and other participants in the firm in determining whether to certify a firm as a DBE. Such consideration shall be in the context of the duties of the persons involved, normal industry practices, the firm's policy and practice concerning reinvestment of income, and any other explanations for the differences proffered by the firm. Recipients may determine that a firm is controlled by its disadvantaged owner although that owner's remuneration is lower than that of some other participants in the firm.

Under the Regulation at §26.71(l), where a firm was formerly owned and/or controlled by a non-disadvantaged individual (whether or not an immediate family member), ownership and/or control were transferred to a socially and economically disadvantaged individual, and the non-disadvantaged individual remains involved with the firm in any capacity, the disadvantaged individual now owning the firm must demonstrate to you, by clear and convincing evidence, that (1) the transfer of ownership and/or control to the disadvantaged individual was made for reasons other than obtaining certification as a DBE; and (2) the disadvantaged individual actually controls the management, policy, and operations of the firm, notwithstanding the continuing participation of a non-disadvantaged individual who formerly owned and/or controlled the firm.

The record further establishes the fact that the two non-disadvantaged owners operated a firm in a similar line of business called Rail Surveyor, before the start of RSE. According to documents found in the record, you have worked for RSE since September of 2000. Subsequently, the record information reveals that the two non-disadvantaged owners have been with RSE since July of 1996. The record evidence establishes that the two non-disadvantaged owners are extremely involved in the firm's day-to-day operations. The Regulation also requires that participating DBE owners enjoy the profits and losses of their businesses in a degree that is commensurate with their ownership interest. Such is not the case with the applicant firm. The Department has reviewed the compensation paid to you, the disadvantaged owner and that of the non-disadvantaged owners and has determined that your compensation is not commensurate with your ownership interest in the business. According to documents contained in the record since the incorporation occurred, Kevin Gray has received significantly higher compensation than that of you, the disadvantaged owner. The CUCP correctly determined that you the disadvantaged owner do not enjoy the customary incidents of ownership nor do you share in the risks and profits commensurate with your ownership interests.

RSE's DBE application appears to show that you share control of this company with the two non-disadvantaged owners, Messrs. Gray and Shock and that all owners are equally responsible for the critical day-to day activities of this business. We conclude, therefore, that control is shared equally by the 3 owners and that this type of arrangement of joint control by the minority and nonminority owners is not a business controlled by the disadvantaged owner as required by the Department's Regulation.

3) The Regulation at §26.71(c) states in part, that a DBE firm must not be subject to any formal or informal restrictions which limit the customary discretion of the disadvantaged owners. There can be no restrictions through corporate charter provisions, by-law provisions, contracts or any other formal or informal devices (e.g., cumulative voting rights, voting powers attached to different classes of stock, employment contracts, requirements for concurrence by non-disadvantaged partners, conditions precedent or subsequent, executory agreements, voting trusts, restrictions on or assignments of voting rights) that prevent the disadvantaged owners, without the cooperation or vote of any non-disadvantaged individual, from making any business decision of the firm.

The record indicates that RSE's Board of Director's consists of five individuals; Phil Leong, Kevin Gray, and his wife Kara (Helsing) Gray, and John Schock and his wife Linda Schock. Without the cooperation of the non-disadvantaged owners and their wives, you cannot make any business decisions for the firm.

Section 4, question 5 of the certification application instructs you to identify Officers and Board of Directors. You listed the board of directors as "Same as Above" (See Below). The CUCP's site visit questionnaire, question 19, asks how many directors do you have on your board of directors and who are they. You stated, the three owners, Linda Schock and Kara Gray.

5. Identify Officers & Board of Directors. *(Attach work experience resumes of each person; if additional space is required, attach a separate sheet)*

	Name	**Title/Date Appointed**	**Ethnicity**	**Gender**
Company Officers	**1. Phil Leong** **2. Kevin C. Gray** **3. John C. Schock** **4. Linda Schock** **5. Kara Helsing**	President 9 /25/01 Vice President 9 /25/01 Secretary 9 /25/01 Asst. Secretary 9 /25/01 CFO 9 /25/01	Asian Pac. Caucasian Caucasian Caucasian Caucasian	Male Male Male Female Female
Board of Directors	**1. Same As Above** **2.** **3.** **4.** **5.**			

The CUCP has determined that you do not actually control the firm because there are formal and informal restrictions that limit the customary discretion of the disadvantaged owner. The record shows that your control is restricted by the corporation's bylaws which provide for management of the business and affairs of the corporation under the direction of the Board of Directors. RSE‘s Bylaws require a super majority vote of more than two-thirds of the outstanding shares in order to create a board of less than five directors. Since the Bylaws require a majority vote of the Board of Directors in order to make important decisions in behalf of the firm, the possibility exists that the non-disadvantaged owners and the spouses could prevent you from making important decisions of RSE. The record also establishes the fact that you, the disadvantaged owner were absent from a special board meeting regarding the firm’s profit sharing and the 401(k) plan. It is clear from the record evidence that important decisions can be made in your absence by the non-disadvantaged owners and their spouses. Also included in the record is a Buy-Sell Agreement that stipulates an expulsion clause that would allow an owner to be expelled upon a unanimous vote of all other owners for adequate cause. The Department realizes that as the owner of the majority of the firm's outstanding shares that you could, at least theoretically, remove the non-disadvantaged owners and their wives from the Board in the event of an impasse. However, we deem this to be highly unlikely given the familial relationship between Board members. The Department has determined that, you are unable to make management decisions without the cooperation of the two non-disadvantaged owners. This is inconsistent with the requirements of the Department’s Regulations.

In your rebuttal you state,

> “The District is incorrect in its statement that the ‘present Board of directors is comprised of Kevin Gray and his spouse, Robert Schock and his spouse and only the disadvantaged owner.’ The Board of Directors per minutes of the first meeting of the board of directors clearly states that a quorum of the full board consisted of Kevin Gray, Phil Leong and John Schock. Kara Helsing and Linda Schock were serving as officers of the Board, not directors.”

The Department has carefully reviewed the entire record in this matter and has determined that John Schock, and Kevin Gray, both non-disadvantaged individuals are disproportionately responsible for the operation of the firm. This conclusion is supported by documents contained in the record such as RSE’s DBE application, CUCP’s on-site evaluation, resumes and other documents. Furthermore, RSE appears at best to be controlled by its Board of Directors. The CUCP has presented clear and convincing evidence to substantiate its decision to deny DBE Certification to RSE.

In summary, the information provided cumulatively supports a conclusion that RSE does not meet the criteria as required for DBE certification under 49 CFR Part 26. The company is, therefore, ineligible to participate as a DBE on the CUCP’s Federal financially assisted projects. This determination is administratively final as of the date of this correspondence.

Sincerely,

Original Signed By

Joseph E. Austin, Chief
External Policy and Program Development Division
Departmental Office of Civil Rights

cc: CUCP